



Monetary Policy's Current Challenges*

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By

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* **Disclaimer:** This presentation represents the personal views of the author, Dr. David Laidler, who is Professor Emeritus, University of Western Ontario, and Fellow in Residence, C.D. Howe Institute

I N D E P E N D E N T • R E A S O N E D • R E L E V A N T

Although monetary policy is not the principal concern of the Department of Finance, in Canada we do have the doctrine of dual responsibility for monetary policy between the Bank of Canada and Finance, so Finance has some responsibilities in the area. Furthermore, in 2011, we are supposed to be having a major overhaul of the inflation-targeting program. The Department of Finance, obviously, is going to be involved in that, it's only two years until we get there, and here we are still in the middle of what people began by calling a financial crisis but which has now become much more – a serious crisis of the macroeconomy.

Monetary policy right now faces two tasks. One is to play its part in coping with the current mess, and the other is to get things into shape for the renewal or revision of the inflation-targeting regime in 2011. In my view, these tasks are complementary.

The first and immediate job for monetary policy is to get the inflation rate back up to 2 percent. Right now we've got a long way to go, but if it can be done over the next 18 months or so, then we shall be in some kind of shape for the renewal of the targeting regime as well. But this complementarity cuts both ways. If we don't get current policy right, the renewal of the regime is potentially at risk, and that would be a real shame, because since 1991 or maybe 1995, it has provided a very useful and stable base for much else in Canadian economic life. It didn't accomplish everything that it was supposed to accomplish ex ante. We're still waiting for the improvement in productivity growth that low and stable inflation was supposed to bring us, but it brought many other gains, and it would be really nice if we could get the basis for these back again after 2011.

Let me now talk a little bit about the current situation and how monetary policy fits into it. The local Canadian problem, as everybody knows now, is not really like those in most parts of the world. To begin with, we have had, and still do have, a functioning financial system. The recession, depression, downturn, or whatever you'd like to call it, did not start in Canada either. Its origins here lay mainly in severely depressed export markets and in a sharp and sudden diminution of foreign lending into Canadian financial markets. The Canadian banking system, with some difficulty, is now beginning to replace the latter, but we aren't quite there yet.

We did have some local sources of financial instability, however, and whenever we pat ourselves on the back for our good performance, we should remember asset-backed commercial paper. The collapse of that market was not pretty and it could have been a lot uglier if people hadn't got on top of the problem very quickly. Also we did have that financial wonder, the 100 percent with 40-years-to-pay mortgage, for a few years, which could have done quite

a bit of damage to the housing market if it had been allowed to stay in place longer. In some respects, then, we've been lucky on the financial front. But the fact remains that, as far as the Canadian macroeconomic situation is concerned, this looks much more like an ordinary recession than it does in a lot of other places, whose financial systems need major repairs.

Now, much of the load of dealing with the recession here and everywhere else too, has been borne by fiscal policy, and, speaking as a historian of economic thought, I've been astonished at how fast everybody has switched back to discussing and implementing remedies based on old-fashioned, post-war Keynesian macroeconomics since this thing started. That is not something that I would have predicted in advance. And I'm bound to say it's not something that I would altogether have supported either. Let me make this point carefully, however. I think built-in fiscal stabilizers are just great, and, like a number of other people, I was worried towards the end of last year that we might be heading for a pro-cyclical fiscal response to the recession, so I'm delighted we didn't get it. As to more active fiscal stimulus, I'm not going to argue against it because that would be futile, but I'm not altogether convinced about how effective it's going to be.

There is quite a bit of experience to suggest that fiscal measures are not all they are cracked up to be, though the most dramatic recent experiments come with the signs reversed, involving as they did fiscal contractions rather than expansions. Let me remind you that the very month in which Margaret Thatcher really cut government spending and went after the UK's deficits was when the UK economy started off on the expansion that became the Thatcher boom. And let me also remind you that the Canadian macro economy under inflation targeting didn't really begin to come right until after 1995, which is precisely when fiscal policy in Canada began to get seriously contractionary. Let me also remind you that Japan had an awful lot of fiscal expansion in the 1990s, and though it didn't fall flat on its face, the performance of the Japanese economy in those years is not something that someone brought up on what, say, Paul Samuelson's third-edition textbook had to say about fiscal policy would have quite expected. So there's a lot of evidence that suggests that fiscal policy working alone is not all that powerful.

And one other point: Canada still has a flexible exchange rate, and to the best of my knowledge and belief, the Mundell-Fleming model of macroeconomic policy in an open economy has not yet been repealed. Perhaps, of course, if everybody does it all around the world at the same time, the Mundell-Fleming effects tend to cancel out across foreign exchange markets, but still – for both empirical and theoretical reasons, I believe that under current Canadian circumstances there is a lot more to be said for relying on monetary policy and for having hopes of monetary policy, than recent public discussion of macroeconomic issues gives credit for.

To come to the next part of my story, then: I'm a little happier now about the way monetary policy is working through the economy than I was even a couple of months ago. I was very concerned until recently that we were headed for a state of affairs that Ralph Hawtrey would have called a "credit deadlock"; a situation in which, though each individual bank and similar institution is lending all that it feels comfortable lending to its customers, who also feel comfortable about the amounts they are borrowing, these individual efforts nevertheless do not add up to enough borrowing and lending at the level of the whole system to create the amount of money growth needed to push aggregate demand back towards a full employment level. I was concerned that the Bank of Canada had not pushed hard enough on the quantitative monetary levers in the last few months of last year, and was remaining unduly hesitant to do so.

Let me explain why I'm now feeling more comfortable. As we all know, monetary policy under inflation targeting is typically designed and implemented in terms of a model that focuses upon the interaction of two interest rates. If you read many modern textbooks, these two interest rates are, on the one hand, a "natural" real rate of interest determined in the real economy by underlying forces of productivity and thrift, suitably adjusted for inflation expectations and, on the other hand, a rate which is set by the central bank. Locally, this is the overnight rate set by the Bank of Canada. If the Bank wants inflation up, it lowers the overnight rate, if it wants to slow the economy to reduce inflation, it raises the overnight rate, and so on.

Now this framework is quite adequate when the economy is battling along more or less at full employment with inflation expectations well anchored to a credible inflation target. There's no question about that. But it is nevertheless a very simplified approximation to something much more complicated, and sometimes the complications that this framework ignores really matter. Consider first of all that natural or normal rate of interest determined by those real factors. There is not one such rate for the whole economy, but one (at least) for every sector of the economy, and what's important about them as far as the conduct of monetary policy is concerned is that they determine the rate of interest that agents are willing to pay to borrow from

the financial system to finance their various activities. And consider secondly, the rates of interest that are important on the lending side. These are the rates of interest those would-be borrowers face from their would-be lenders, the commercial banks system and similar institutions. Again there is not one, but an array of such rates, depending upon the sector of the economy and the nature of the activity to be financed, and crucially, the overnight rate set by the Bank of Canada is not one of them. Monetary policy always works by making banks and other institutions more or less willing to ease or tighten the terms on which they offer loans, and there are many more ways for the Bank to do that than by varying the rate of interest at which those institutions can borrow and lend among themselves overnight. In stable times, this tool is adequate, reliable and easy to use, and because times have been stable for more than a decade, central banks such as the Bank of Canada have got into the habit of focussing exclusively upon it

But in less quiet times, particularly when the economy is shrinking, the overnight rate loses its effectiveness as it is pushed down to levels close to zero, and here those measures which have recently been given such rather exotic labels as “credit easing” and “quantitative easing,” come into their own. But it has always been open to the Bank of Canada to make the banking system willing to ease its lending terms by swapping treasury bills for private sector paper and hence increasing the liquidity of the system’s portfolio; and it has always been possible for the Bank of Canada to shift government deposits off its own books and onto the banking system’s books, again increasing its liquidity and willingness to lend. In quiet times it just hasn’t been necessary to use these tools. Last autumn, however, when the overnight rate began to run out of steam, it did become necessary, and the Bank was slow to switch its tactics. It put treasury bills into the system and took private paper out quite smartly, even getting the rules about just what it could and could not do on this front loosened up, but in my view it should have sent the overnight rate down closer to zero quite a bit earlier than it did by increasing the supply of cash in the clearing system. I suspect that the bank hesitated here, because it was unwilling to get too far away too quickly from its standard finely honed, and widely understood policy model.

Be that as it may, to supplement and ultimately replace a policy regime based on the overnight rate with one that relies on increasing stocks of liquid assets – treasury bills and cash – is not a radically new policy. It simply involves the pursuit of the same old intentions to ease up the lending habits of the banking system by other means. It is another way of implementing the same old expansionary monetary policy.

My introducer today was kind enough to mention my book *The Demand for Money*. That was first published 40 years ago now, and I’m afraid I am still one of those old-fashioned people who unrepentantly believes that monetary policy works through two channels. The first is the direct impact on borrowing, lending and expenditure decisions of interest rate changes, such as I’ve already described. The second relies on the consequences – for the portfolio composition of the non-banking sector of the economy – of changes in the volume of those banking sector liabilities, otherwise known as deposit money, that get created as a by-product of the processes of borrowing and lending.

Now, there was a time when we thought that if you focused on this latter channel alone and controlled the rate of money growth, you could stabilize the macroeconomy. That turned out to be over optimistic. The behaviour of neither the supply nor demand for money is stable enough over time to enable a central bank that wants to take a policy decision every six weeks or so to be guided by this variable. But this doesn’t alter the fact that the interaction of the supply and demand for money is nevertheless at the heart of monetary policy’s transmission mechanism. It just means that this market is not stable enough for policy to rely on simple rules for the behaviour of its supply side.

So why am I happier now than I was a few months back? Well, I don’t know if people in this room have inspected the money growth figures lately, but I have. The Bank of Canada still publishes them, and since roughly November or December, the growth rates of the narrower expenditure-related monetary aggregates M1+ and M1++ have gone from single digits – the 7-to-8 percent range – up to 14 or 15 percent right now, and they still seem to be accelerating. I simply cannot bring myself to believe that monetary policy is not now highly stimulative, even though, of course it has a lot of contractionary factors coming from elsewhere to push against. Nobody estimates demand for money functions anymore, but my former colleague at the C.D. Howe Institute, Robin Banerjee, ran a few regressions. To cut a long story short, the implications of his work, to the extent that it is safe to derive them because it was pretty preliminary, was that if you have growth in the narrow aggregates much in excess of 7 or 8 percent per annum, you’ve got expansionary monetary policy,

and, as I've noted money is now growing at twice that pace. So I do believe that monetary policy is now actually pushing pretty hard, and therefore that those forecasts of an upturn in the economy around the end of this year are looking more realistic.

I say this even though the inflation rate at the moment is running at or even a little below zero, and that if you want to estimate the stimulus being imparted by monetary policy by just looking at nominal interest rates, you had better allow for the fact that the inflation expectations relevant for shorter-term expenditure decisions have probably fallen by a couple of percentage points in the last 18 months. This phenomenon also had me very worried at the beginning of the year, but rapid money growth is beginning to dissipate my concerns for the longer term.

So far, so good for 2010's economic prospects, then? Well maybe: but there are a few other shoes that might drop around the world. Let me just mention one or two of these. The German banks don't look very healthy to me, and there's stuff going on in the Baltics with the Swedish banks that I don't altogether understand, so there might be trouble there too, while Swiss and Austrian banks hold a lot of mortgages in Hungary that seem to be denominated in Euros and Swiss francs and these don't look very sound at the moment either. However, I draw some comfort from the thought that, after Northern Rock and Lehman Brothers, etc., I don't think anybody's actually going to let any other major institution fold, so I presume that if any of the above shoes do drop, they will be smartly picked up again by the relevant authorities.

Over the longer term, however, there are some issues closer to home that are beginning to have me concerned. They are not here yet but they will be once the economy bottoms out and begins to expand, so it is not too early to start discussing them. Specifically, we need to begin to worry about how far and fast the economy can expand before it begins to generate renewed inflationary pressures that will need a monetary policy response.

Right now unemployment is high and rising, and capacity utilization measures are quite horrendous. If you read the latter at face value – a capacity utilization rate of just over 70 percent, and I think that's about as low as it's ever been in Canada since the series started – it looks as if there's a lot of slack out there. But I wonder how much there really is. It's a lot easier to shut a factory or a mill down than it is to get it up and working again, so once it has been shut down, even ultimately usable capacity can't always be brought back on stream in a matter of weeks. It can take months or even quarters. Also, living as I do in South Western Ontario, I can't help but look at some of the older auto-parts plants and assembly plants and so on that have recently closed, and wonder how much of the capacity that we are measuring as currently idle is ever likely to be usable again under any reasonable scenario. And it would not surprise me to learn that similar worries can be justified about other parts of the country as well.

In short, that slow recovery that everybody is now talking about is going to be slow not just because of sluggishness on the demand side of the economy, but also perhaps because of constraints on the supply side that are not going to permit it to go any faster in real terms. And now you can see where I'm driving. If the supply side of the economy has been impaired to any serious degree by recent events, even quite slow demand growth is going to start creating inflationary pressures. And if it does, then monetary – not to mention fiscal – policy is going to have to start tightening up at a time when the economy is still expanding sluggishly, when the labour force is being pulled back into employment quite slowly, when we are running below traditional expectations about feasible real economic growth. And it is going to be politically really difficult, no matter how economically wise it might be, to stop incipient inflationary pressures building up by taking the steps that will rein in those double-digit rates of money growth.

There will be lots of scope, that is to say, for reviving old arguments about the Bank of Canada's obsession with inflation and its lack of concern about the real economy, particularly since similar arguments are likely to be going on south of the border, and we should not entirely rule out a rerun of type of politics of monetary policy that we last saw in the early '90s – and perhaps of fiscal policy too. None of this is certain, and it isn't a problem for mid-2009. But it could be an issue by the spring of next year, so it is worth thinking about now.

Discussions about the importance of stabilizing the debt-to-GDP ratio or even starting to reduce it again, and about the virtues of balanced budgets, are nothing new in the Department of Finance. The fact that these ideas are so widely accepted nowadays among voters at large marks a strong point of contrast to situation in the early 1990s, so I am all for us continuing to cultivate this mindset. If I'm right about the Canadian economy's rather low potential for renewed real growth, however, I don't

see how we're going to be able to do that over the next little while without being willing to consider increasing taxes, and that too is going to be politically difficult.

So let me offer you, and my tongue is not in my cheek as I do so – at least not very far – Laidler's solution to this dilemma: the "Debt Stabilization (or Deficit Elimination) GST Surcharge," with its implicit hint that this might be a temporary measure if things work out better than expected on the growth front. I know that this is not going to be a really popular suggestion in this city; that the Department of Finance can't put out working papers explaining what a good idea it would be, and that leaders of the major political parties can't support such a proposal either. But I also think that these facts put some burden on the economics profession to start getting out there and arguing along such lines. It was probably not a good idea to lower the GST in the first place, because it was a nice, relatively non-distorting tax on consumption, but that is water-under-the-bridge now. Importantly, though, it will not do very much damage to the economy's performance if it is increased again, which is more than one can say for many other taxes.

When I was an undergraduate, they used to call the purchase tax in the United Kingdom "the regulator," and the Chancellor of the Exchequer used to move it up and down in almost every budget and sometimes between budgets as well as he tried to fine tune the economy. Though I wouldn't recommend a return to this kind of naïve policy activism, it remains a fact that the ease with which an economy-wide sales tax can have its rate adjusted is one of its great virtues, and that's why Canada is lucky to have one in current circumstances, and why the Americans are unlucky. We should be prepared to exploit our advantage here.

Perhaps that's enough about fiscal virtue for now, except to remind ourselves that if we don't practice it in the long run, monetary virtue will become more and more difficult to maintain. But let us now suppose that we do practice both over the next couple of years, and hence get to 2011 with an economic outlook that makes the renewal and maybe modification of the inflation targeting agreement feasible. What should we be thinking of doing then?

Let me begin with a couple of issues that are creeping onto the monetary policy agenda and which I don't like. First – no surprise to anybody who's read my work over the last few years – I don't much like the Bank of Canada making pronouncements about how exchange rates should behave, and what it might do about it in the event of disobedience. It was true before the current crisis that you can either control inflation or the exchange rate but not both and it's still true. Moreover, unless you're an economic planner – which I am not – you haven't the faintest idea how the economic restructuring of places like South Western Ontario is going to evolve, and you're going to want to leave it to the private sector. And it's going to be really important to ensure that the private sector gets the right signals from market prices to guide its activities. One of the worst things you could do is use monetary policies that risk sending misleading signals about the exchange rate to agents who are trying to decide what can and cannot be produced for export, and to where in what quantities.

I do not accept the view that signs of weakness in the US dollar are likely mainly tied to portfolio readjustments associated with US deficits. There are long run real factors at work here too. Old style expenditure patterns led by the US consumer will not return, because no one is going to lend to the US consumer again on the old terms, and the US savings rate is going to be permanently higher. The US government can't fill the gap between savings and investment forever – that's where deficit worries come in – so to get the US back to full employment again exports are going to have to grow, and a lower US dollar is going to be part of that story.

I'm not here forecasting the collapse of the US dollar as a reserve currency. On the contrary, I think there's ample evidence from the rush into US government securities every time there's a financial hiccup somewhere, that the network externalities that have long supported the US dollar as the international currency par excellence are still very strong. But that doesn't rule out a secular decline in the US real exchange rate, which I think we're going to get, and it's going to affect the US-Canadian exchange rate. We shall have to live with that as the private sector goes ahead with restructuring the Canadian economy, and a policy towards the exchange rate that tries to hide its effects will do no-one a favour in the long run..

The other suggestion that is currently getting too popular for my comfort is that somehow we should allow concerns about maintaining macro-financial stability to complicate the conduct of monetary policy by inflation targeting central banks, that we should give them the additional task of pre-empting financial market bubbles with their interest rate policies. I really hope they don't do this, for a number of reasons.

First, inflation targeting didn't cause the recent crisis. We did not have a bubble-prone financial system in Canada under inflation targeting. They did in the US, but they didn't have formal inflation targeting, and I find it hard to believe that that last Greenspan boom would have been allowed to go as far and as long as it did if they had been bound a formal 2 percent inflation target for the CPI. The UK is an inflation targeter, to be sure, but they target the Harmonized European Price Index, not the local retail price index, and that harmonized index gives exactly zero weight to owner-occupied housing. Imagine that, in an economy where 70-odd percent of the households are owner-occupiers and a housing boom is in progress! Retail price inflation in the UK got to over 5 percent in the run-up to the crash there.

Furthermore, though monetary policy has more tasks than targeting the general price level, it has more tools too. There is regulation: by all means, let the regulators start worrying more than they did in the past about the consequences of the behaviour of particular institutions, or particular groups of institutions, for the stability of the financial system as a whole, let them have powers to deal with these matters if they don't have them already, and by all means give the central bank, which does have a particularly helpful vantage point from which to view these developments a role in prompting regulatory responses. This is surely what the Bank of Canada was doing when Governor Dodge started drawing attention to the likely market-wide consequences of 100 percent and 40-years-to-pay mortgages, and it seems to me to have been quite appropriate for him to do so. We may well need more behaviour of this type in the future.

But, we don't need the Bank to start using its general monetary policy instruments – the overnight rate etc. – to try to preempt market bubbles. Earlier, I pointed out that the monetary policy mechanism is a bit more complicated than what is in the textbooks. There is an array of “natural” interest rates on the demand side, not just one, and if you actually look at the history of booms and busts, most of them have names. There's the Mississippi bubble, the South Sea bubble, There were railway manias and railway booms, an electricity boom, a chemical boom, a Florida real estate bubble, more recently a high-tech boom and a dotcom bubble, and last but not least, a housing boom. These names all refer to the specific sectors of the economy where the booms and bubbles got going because the “natural” rates ruling there moved to unsustainably high levels. Such sector specificity is perhaps not quite universal – Japan did have a “bubble economy” after all – but it is typical.

In Canada we're used to the argument that you cannot gear monetary policy to the economic behaviour – boom, bust or what have you – of particular geographic regions of the economy. We know that you can only have one monetary policy for the economy as a whole. You can't have one policy for Atlantic Canada, another for the West Coast, another for Ontario. Well, what I would suggest is that you can't have separate monetary policies for individual sectors of the economy either, and that the use of the overnight rate, or any other general monetary policy tool to try to control booms and bubbles is not appropriate. That's a job for the regulators, by all means regulators who are well informed about the overall macroeconomic situation, and who also understand, that though asset market bubbles are usually sectoral matters when developing, they can have system- and indeed economy-wide consequences when they collapse.

And one final note: if regulation sometimes fails, as it surely will from time to time, the central bank's exercise of its lender of last resort powers to maintain or restore systemic stability is complementary to the pursuit of stable inflation, not a distraction from the task.

But what should the post 2011 framework look like? We know that the Bank of Canada has been thinking about doing two things, and for all I know so has the Department of Finance: namely, lowering the inflation target from 2 percent, which is where it got stuck some time in the 1990s through nobody's careful calculation – and perhaps zero is after all a nice round number? – and moving to a target for the time path for the price level rather than inflation itself. I still don't definitively know where I stand on either of these particular two issues, so I'm not going to take a normative position on either issue here.

However, I do have an uncomfortable feeling that as a matter of the practical facts of politics, it's going to be really difficult to lower the target inflation rate in the next two years. After all, any serious changes to be made in 2011 will have to be on the table for debate some time in 2010. And in 2010, with luck, we shall be coming out of a recession in which the actual inflation rate will be moving back up towards 2 percent, having been close to zero or even slightly negative for the previous 18 months or so. It's going to be really difficult to say “Guess what? Starting next year we're going to take it back to zero again.” That just doesn't sound like good politics to me.

At the same time, the longer time horizon for monetary policy that is implicit in a price-level target will also be a hard sell. We're now arguing that maybe by the end of 2010, inflation might be back to 2 percent, having been below that target for about two years. The length of that shortfall might have strained the credibility of monetary policy in general by then, and if it has done so, then the time will not be ideal to introduce a more complicated form of targeting that will require the public to have even more faith in the authorities' willingness and abilities to persevere over an even longer horizon to keep things on track. We shall have to see how inflation expectations in particular, and the credibility of macroeconomic policy in general, evolve over the next little while before we shall know how serious an issue this is

I do think, however, that the credibility of monetary policy has been impaired by the still evolving economic crisis, and I do think we've got to be careful to repair it before we start making significant changes to the regime, so I wouldn't be surprised if yet again we get stuck with the old 2 percent target, not because anyone thinks that this is the best we can do, but because, yet again, the administrative opportunity for change it has arrived in inopportune economic circumstances.. But, still, being stuck with 2 percent is not all bad.

Let me then repeat and slightly extend at the end of this talk what I said at its beginning. We don't have 2 per cent inflation right now, and monetary policy's first task is to get it back there. If it does, and we now seem to be moving in the right direction, we might find ourselves in a position to move to a better regime after 2011. But if we are to have any chances here, we must be careful at this stage – not just to get inflation moving up, but also to make sure that it doesn't get onto a track along which it ends up moving too fast for comfort.